BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WILLIAMSON ASSOCIATES)

Appearances:

For Appellant: Robert C. Harris and Julian N. Stern, Attorneys at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Williamson Associates to proposed assessments of additional franchise tax in the amounts of $11,023.92, $17,934.75, $18,159.92, $23,484.51 and $21,508.82 for the income years 1951, 1952, 1953, 1954 and 1955, respectively.

Appellant is a corporation. It conducted a coin machine business in San Francisco. It owned bingo pinball machines, flipper pinball machines and shuffleboards. The equipment was placed in bars, restaurants, and other locations. The proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between Appellant and the location owner. Equipment, was placed in about 100 locations.

Appellant also owned claw machines. These were placed in about 25 locations. Gut of the proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, half went to the location owner and half was retained by the collector. The collector turned in his collections to Appellant and received a commission of a certain percentage thereof. George Williamson told Respondent's auditor in 1957 that the claw machine collectors were employees of Appellant. (Mr. Williamson carried the title of secretary-treasurer but was in fact the principal managing officer. He died prior to the hearing in this appeal.)

In addition, Appellant owned music machines. Appellant and Respondent agree for the purposes of this appeal that Appellant leased the music machines to another route operator. This operator serviced the machines, and paid a percentage of his

receipts to Appellant as rental.

In 1954 Appellant purchased a group of pinball machines which were already leased to a route operator for a fixed monthly rental per machine. Appellant had nothing to do with the operation of these machines but derived income from the lease during 1954 and 1955.

The gross income included on Appellant's records and tax returns was the total of amounts retained from locations as to pinball machines, claw machines and shuffleboards. Appellant also entered as gross income the rental received from the lessees of the pinball and music machines. Deductions were taken on the tax returns for salaries, depreciation and other business expenses.

Respondent determined that, except as to music machines, Appellant was renting space in the locations where its machines were placed and that all the coins deposited in these machines constituted gross income to Appellant. Respondent also disallowed all expenses, music machine depreciation excepted, pursuant to Section 24436 of the Revenue and Taxation Code (Section 24203 of the Revenue and Taxation Code from July 1, 1951, to June 5, 1955, and Section 8.01 of the Bank and Corporation Franchise Tax Act from May 3, 1951, to June 30, 1951.) Section 24436 reads:

> In computing net income, no deductions shall be allowed to any taxpayer on any of its gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Tart 1 of the Penal Code of California; nor shall any deduction be allowed to any taxpayer on any of its gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

As to the claw machines, we conclude that Appellant rather than the collectors was the principal. This conclusion is based on George Williamson's statement to Respondent's auditor and on Appellant's method of recording the income on its records and tax returns.

The evidence indicates that, except as to leased pinball and music machines, the operating arrangements between Appellant and each location owner were the same as those considered by us in Appeal of Hall, Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par. 58145. Our conclusion in Hall that the machine owner and each location owner were engaged a joint venture in the operation of the machines is, accordingly, applicable here.

The leased pinball machines would appear to be similar to the leased music machines insofar as Appellant's gross income was concerned. Since Appellant had nothing to do with placement, collections or service on the leased pinball machines, its only gross income therefrom was the amount of rental received from the route operator.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par. _____ 2 P-H State & Local Tax Serv. Cal. Par. _____, we concluded that the ownership or possession of a pinball machine was illegal under Penal Code Sections 330b, 330.1 and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games, and we also concluded that a bingo pinball machine was predominantly a game of chance. In Appeal of Gallitero, Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par. ____, 3 P-H State & Local Tax Serv. Cal. Par. ____, we held the ownership or possession of flipper pinball machines to be illegal under the same Penal Code provisions if cash was paid to players for unplayed free games.

Respondent's auditor testified that George Williamson told him in 1957 that payouts were made on all pinball machines and that of the total coins in the pinball machines, one-third went to the players, one-third to the location owners and one-third to Appellant. Another officer of Appellant testified that payouts were made on bingo pinball machines and that they averaged one-third of the amounts in those machines. A former employee of Appellant also appeared and stated that the location owners claimed reimbursement of approximately one-third of the machine proceeds. Finally, two location owners who had pinball machines from Appellant testified that they paid cash to players for unplayed free games. One of the location owners testified that he made such payouts with respect to flipper pinball machines.

We conclude that it was the general practice to pay cash for unplayed free games to players of Appellant's bingo pinball machines and that such payouts were made as to at least some of the flipper machines. Accordingly, there was illegal activity in the ownership and possession of bingo pinball machines, which were predominantly games of chance, and in the payment of cash to winners on both types of machines. We have previously held the operation of a claw machines to be illegal whether or not a successful player is permitted to redeem the merchandise for cash. (Appeal of Perinati, Cal. St. Bd. of Equal., Apr. 6, 1961, 3 CCH Cal. Tax Cas. Par. 201-733, 3 P-H State & Local Tax Serv. Cal. Par. 58191; Appeal of Seeman, Cal. St. Ed. of Equal., July 19, 1961, 3 CCH Cal. Tax Cas. Par. 201-825,3 P-H State & Local Tax Serv. Cal. Par. 58208.) Inasmuch as there was illegal activity, Respondent was correct in applying Section 24436.

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Respondent has considered the music machines leased to a route operator as not connected or associated with the pinball and claw machines operated by Appellant. On a similar basis it is our view that the pinball machines leased to a route operator were not connected or associated with the pinball and claw machines operated by Appellant. Therefore the only bases for disallowing the expenses related to the leased pinball machines would be if they were predominantly games of chance or if cash was paid to winning players. As to the leased pinball machines the record contains no evidence concerning the type of machines nor evidence indicating whether cash was paid to winning players. Respondent made no investigation of this subject. On this state of the record we cannot hold that the leased pinball machines involved an illegal activity. In the absence of even an attempt by Respondent to ascertain the facts we cannot invoke any presumption of correctness that might otherwise attach to Respondent's actions.

The allowable expenses are the direct expenses of the leased music and pinball machines. These are depreciation, cost of phonograph records, and tax and license fees. Overhead expenses would appear to relate solely to the active route operation business and not to the rather passive business of receiving rent from a route operator.

As to the claw and pinball machines on Appellant's own routes there were not complete records of amounts paid to winning players or of amounts taken from the machines for payment of taxes. Respondent estimated these amounts as equal to 80 percent of the total deposited in the machines in the case of claw machines and as equal to 50 percent of the total deposited in the machines in the case of pinball machines.

The 80 percent estimate on claw machines was based on partial records for 1951 and 1952 indicating about 63 percent of the total going to winning players. In view of the $250 annual federal tax on claw machines Respondent estimated that taxes and licenses would account for 15 percent of the total deposited in the machines and rounded the result up to 80 percent. Respondent's tax estimate necessarily assumes that each claw machine takes in somewhat less than $5.00 a day. Judging from the record, available to us $5.00 a day would be rather low for a claw machine. We believe that a more accurate estimate of the unrecorded receipts of claw machines would be that they were equal to 70 percent of the total deposited in the machines.

The 50 percent estimate on pinball machines was arrived at as a matter of general policy but was not supported by any records or by statements of location owners, collectors or other persons having knowledge of the facts.

As we have previously indicated, three persons connected with Appellant estimated that the payments to winning players amounted to about one-third of the proceeds of the pinball machines but one of these persons limited his estimate to bingo pinball machines. A location owner, on the other hand, testified that he paid cash for unplayed free games on flipper pinball machines. We have not been informed of the relative importance of Appellant's flipper pinball machines as compared to its bingo pinball machines either as to number or as to income produced.

Although the record is somewhat confusing, it is necessary for us to reach a specific conclusion. Our conclusion is that the unrecorded receipts of pinball machines should be computed as equal to 33-1/3 percent of the total deposited in all pinball machines operated by Appellant.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Williamson Associate to proposed assessments of additional franchise tax in the amount of $11,023.92, $17,934.75, $18,159.92, $23,484.51 and $21,508.82 for the income years 1951, 1952, 1553, 1354 and 1955, respectively, be modified in that the gross income and disallowance of expenses are to be recomputed in accordance with the opinion of the Board.

Done at Sacramento, California, this 10th day of January, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary